REPORT OF THE AUDIT OF THE FORMER LEE COUNTY SHERIFF'S SETTLEMENT - 2006 TAXES

For The Period
June 4, 2006 Through December 31, 2006

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EXECUTIVE SUMMARY

AUDIT EXAMINATION OF THE
FORMER LEE COUNTY
SHERIFF'S SETTLEMENT - 2006 TAXES

For The Period
June 4, 2006 Through December 31, 2006

The Auditor of Public Accounts has completed the audit of the Sheriff's Settlement - 2006 Taxes for former Lee County Sheriff for the period June 4, 2006 through December 31, 2006. We have issued an unqualified opinion on the financial statement taken as a whole. Based upon the audit work performed, the financial statement is presented fairly in all material respects.

Financial Condition:

The former Sheriff collected taxes of $1,425,324 for the districts for 2006 taxes, retaining commissions of $60,089 to operate the Sheriff's office. The former Sheriff distributed taxes of $1,362,842 to the districts for 2006 Taxes. Taxes of $2,037 are due to the districts from the former Sheriff.

Report Comments:

- The Former Sheriff Should Have Distributed Interest On A Monthly Basis
- The Former Sheriff Should Have Required The Depository Institution To Pledge Or Provide Sufficient Collateral And Entered Into A Written Agreement To Protect Deposits
- The Former Sheriff's Office Lacked Adequate Segregation Of Duties

Deposits:

The former Sheriff's deposits as of November 30, 2006 were exposed to custodial credit risk as follows:

- Uncollateralized and Uninsured $539,838

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CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

To the People of Kentucky
Honorable Steven L. Beshear, Governor
Jonathan Miller, Secretary
Finance and Administration Cabinet
Honorable Steve Mays, Lee County Judge/Executive
Honorable Harvey Pelfrey, Former Lee County Sheriff
Honorable Donnie Hogan, Lee County Sheriff
Members of the Lee County Fiscal Court

Independent Auditor's Report

We have audited the former Lee County Sheriff's Settlement - 2006 Taxes for the period June 4, 2006 through December 31, 2006. This tax settlement is the responsibility of the former Lee County Sheriff. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States, and the Audit Guide for Sheriff's Tax Settlements issued by the Auditor of Public Accounts, Commonwealth of Kentucky. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, the Sheriff's office prepares the financial statement on a prescribed basis of accounting that demonstrates compliance with the modified cash basis, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, the accompanying financial statement referred to above presents fairly, in all material respects, the former Lee County Sheriff's taxes charged, credited, and paid for the period June 4, 2006 through December 31, 2006, in conformity with the modified cash basis of accounting.

In accordance with Government Auditing Standards, we have also issued our report dated January 29, 2008 on our consideration of the former Sheriff's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing,

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and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audit.

Based on the results of our audit, we present the accompanying comments and recommendations, included herein, which discusses the following report comments:

- The Former Sheriff Should Have Distributed Interest On A Monthly Basis
- The Former Sheriff Should Have Required The Depository Institution To Pledge Or Provide Sufficient Collateral And Entered Into A Written Agreement To Protect Deposits
- The Former Sheriff's Office Lacked Adequate Segregation Of Duties

Respectfully submitted,

Crit Luallen
Auditor of Public Accounts

January 29, 2008

LEE COUNTY
HARVEY PELFREY, FORMER SHERIFF
SHERIFF'S SETTLEMENT - 2006 TAXES

For The Period June 4, 2006 Through December 31, 2006

Charges	County Taxes	Special Taxing Districts	School Taxes	State Taxes
Real Estate	$ 500,916	$ 243,729	$ 447,086	$ 191,395
Tangible Personal Property	94,243	29,187	42,501	45,532
Fire Protection	2,606			
Franchise Taxes	69,323	21,500	31,137	
Additional Billings	1,084	530	976	412
Bank Franchises	18,056			
Penalties	16	5	10	6
Adjusted to Sheriff's Receipt	661	370	678	240
Gross Chargeable to Sheriff	686,905	295,321	522,388	237,585
Credits				
Exonerations	13,475	5,258	8,751	7,274
Discounts	7,461	3,248	5,818	2,721
Incoming Sheriff's Official Receipt	96,217	45,567	82,948	38,137
Total Credits	117,153	54,073	97,517	48,132
Taxes Collected	569,752	241,248	424,871	189,453
Less: Commissions *	24,502	10,253	16,995	8,339
Taxes Due	545,250	230,995	407,876	181,114
Taxes Paid	544,286	230,554	407,015	180,987
Refunds (Current and Prior Year)	116	62	124	54
Due Districts		**		
Due Sheriff as of Completion of Audit	$ 848	$ 379	$ 737	$ 73

*and ** See Next Page.

LEE COUNTY
HARVEY PELFREY, FORMER SHERIFF
SHERIFF'S SETTLEMENT - 2006 TAXES
For The Period June 4, 2006 Through December 31, 2006
(Continued)

*Commissions:

10%	on	$	10,000
4.25%	on	$	990,453
4%	on	$	424,871
1%	on	$	0

** Special Taxing Districts:

Library District	$ 139
Health District	96
Extension District	68
Soil Conservation District	76
Due Districts	$ 379

LEE COUNTY
NOTES TO FINANCIAL STATEMENT

December 31, 2006

Note 1. Summary of Significant Accounting Policies

A. Fund Accounting

The Sheriff's office tax collection duties are limited to acting as an agent for assessed property owners and taxing districts. A fund is used to account for the collection and distribution of taxes. A fund is a separate accounting entity with a self-balancing set of accounts. Fund accounting is designed to demonstrate legal compliance and to aid financial management by segregating transactions related to certain government functions or activities.

B. Basis of Accounting

The financial statement has been prepared on a modified cash basis of accounting. Basis of accounting refers to when charges, credits, and taxes paid are reported in the settlement statement. It relates to the timing of measurements regardless of the measurement focus.

Charges are sources of revenue which are recognized in the tax period in which they become available and measurable. Credits are reductions of revenue which are recognized when there is proper authorization. Taxes paid are uses of revenue which are recognized when distributions are made to the taxing districts and others.

C. Cash and Investments

At the direction of the fiscal court, KRS 66.480 authorizes the Sheriff's office to invest in the following, including but not limited to, obligations of the United States and of its agencies and instrumentalities, obligations and contracts for future delivery or purchase of obligations backed by the full faith and credit of the United States, obligations of any corporation of the United States government, bonds or certificates of indebtedness of this state, and certificates of deposit issued by or other interest-bearing accounts of any bank or savings and loan institution which are insured by the Federal Deposit Insurance Corporation (FDIC) or which are collateralized, to the extent uninsured, by any obligation permitted by KRS 41.240(4).

Note 2. Deposits

The former Sheriff maintained deposits of public funds with depository institutions insured by the Federal Deposit Insurance Corporation (FDIC) as required by KRS 66.480(1)(d). According to KRS 41.240(4), the depository institution should pledge or provide sufficient collateral which, together with FDIC insurance, equals or exceeds the amount of public funds on deposit at all times. In order to be valid against the FDIC in the event of failure or insolvency of the depository institution, this pledge or provision of collateral should be evidenced by an agreement between the Sheriff and the depository institution, signed by both parties, that is (a) in writing, (b) approved by the board of directors of the depository institution or its loan committee, which approval must be reflected in the minutes of the board or committee, and (c) an official record of the depository institution. These requirements were not met, as the former Sheriff did not have a written agreement with the bank.

Note 2. Deposits (Continued)

Custodial Credit Risk - Deposits

Custodial credit risk is the risk that in the event of a depository institution failure, the Sheriff's deposits may not be returned. The former Sheriff did not have a deposit policy for custodial credit risk but rather followed the requirements of KRS 41.240(4). On November 30, 2006, $539,838 of the Sheriff's bank balance was exposed to custodial credit risk as follows:

- Uninsured and Unsecured $539,838

Note 3. Tax Collection Period

The real and personal property tax assessments were levied as of January 1, 2006. Property taxes were billed to finance governmental services for the year ended June 30, 2007. Liens are effective when the tax bills become delinquent. The collection period for these assessments was September 29, 2006 through December 31, 2006.

Note 4. Interest Income

The former Lee County Sheriff earned $652 as interest income on 2006 taxes. The former Sheriff distributed the appropriate amount to the school district as required by statute, and the remainder will be used to operate the Sheriff's office. As of January 29, 2008, the former Sheriff owed $46 in interest to the school district and $152 in interest to his fee account.

Note 5. Unrefundable Duplicate Payments And Unexplained Receipts Should Be Escrowed

The former Sheriff should have deposited any unrefundable duplicate payments and unexplained receipts in an interest-bearing account. According to KRS 393.110, the former Sheriff should have properly reported annually to the Treasury Department any unclaimed moneys. After three years, if the funds have not been claimed, the funds should be submitted to the Kentucky State Treasurer. For the 2006 taxes, the Sheriff had $1,528 in unrefundable duplicate payments and unexplained receipts. Therefore, a written report should be sent to the Treasury Department.

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON
COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF THE FINANCIAL
STATEMENT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

The Honorable Steve Mays, Lee County Judge/Executive
Honorable Harvey Pelfrey, Former Lee County Sheriff
Honorable Donnie Hogan, Lee County Sheriff
Members of the Lee County Fiscal Court

Report On Internal Control Over Financial Reporting And On
Compliance And Other Matters Based On An Audit Of The Financial
Statement Performed In Accordance With Government Auditing Standards

We have audited the Lee County Sheriff's Settlement - 2006 Taxes for the period June 4, 2006 through December 31, 2006, and have issued our report thereon dated January 29, 2008. The Sheriff prepares his financial statement in accordance with a basis of accounting other than generally accepted accounting principles. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the former Lee County Sheriff's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the former Lee County Sheriff's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the former Lee County Sheriff's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However as discussed below, we identified a certain deficiency in internal control over financial reporting that we consider to be a significant deficiency.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with the modified cash basis of accounting which is a basis of accounting other than generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statement that is more than inconsequential will not be prevented or detected by the entity's internal control over financial reporting. We consider the deficiency described in the accompanying comments and recommendations to be a significant deficiency in internal control over financial reporting.

- The Former Sheriff 's Office Lacked Adequate Segregation Of Duties

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Internal Control Over Financial Reporting (Continued)

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statement will not be prevented or detected by the entity's internal control. Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we consider the significant deficiency described above to be a material weakness.

Compliance And Other Matters

As part of obtaining reasonable assurance about whether the former Lee County Sheriff's Settlement – 2006 Taxes for the period June 4, 2006 through December 31, 2006 is free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under Government Auditing Standards and which are described in the accompanying comments and recommendations.

- The Former Sheriff Should Have Distributed Interest On A Monthly Basis
- The Former Sheriff Should Have Required The Depository Institution To Pledge Or Provide Sufficient Collateral And Entered Into A Written Agreement To Protect Deposits

This report is intended solely for the information and use of management, the Lee County Fiscal Court, and the Kentucky Governor's Office for Local Development and is not intended to be and should not be used by anyone other than these specified parties.

Respectfully submitted,

Crit Luallen
Auditor of Public Accounts

January 29, 2008

<u>COMMENTS AND RECOMMENDATIONS</u>

LEE COUNTY
HARVEY PELFREY, FORMER SHERIFF
COMMENTS AND RECOMMENDATIONS

For the Period June 4, 2006 Through December 31, 2006

STATE LAWS AND REGULATIONS:

The Former Sheriff Should Have Required The Depository Institution To Pledge Or Provide Sufficient Collateral And Entered Into A Written Agreement To Protect Deposits

On November 30, 2006, $539,838 of the former Sheriff's deposits of public funds were uninsured and unsecured. According to KRS 66.480(1)(d) and KRS 41.240(4), financial institutions maintaining deposits of public funds are required to pledge securities or provide surety bonds as collateral to secure these deposits if the amounts on deposit exceed the $100,000 amount of insurance coverage provided by the Federal Deposit Insurance Corporation (FDIC). The Sheriff should require the depository institution to pledge or provide collateral in an amount sufficient to secure deposits of public funds at all times. We also recommend the Sheriff's office enter into a written agreement with the depository institution to secure the Sheriff's interest in the collateral pledged or provided by the depository institution. According to federal law, 12 U.S.C.A. § 1823(e), this agreement, in order to be recognized as valid by the FDIC, should be (a) in writing, (b) approved by the board of directors of the depository institution or its loan committee, which approval must be reflected in the minutes of the board or committee, and (c) an official record of the depository institution.

Former Sheriff's Response: None.

The Former Sheriff Should Have Distributed Interest On A Monthly Basis

According to KRS 134.140(3)(b), on a monthly basis the former Sheriff shall pay to the board of education that part of his investment earnings for the month which is attributable to the investment of school taxes. The former Sheriff earned $652 in interest for the entire collection period. The former Sheriff did not write checks for each month but only distributed interest to the school and fee account in February of 2007. We recommend that the Sheriff's office distribute interest monthly as required by KRS 134.140(3)(b).

Former Sheriff's Response: None.

INTERNAL CONTROL - MATERIAL WEAKNESSES:

The Former Sheriff's Office Lacked Adequate Segregation Of Duties

The former Sheriff's office lacked a proper segregation of duties because the bookkeeper received all funds, prepared the daily checkout sheets, and also prepared the bank deposits. In addition, the bookkeeper recorded the receipts in the receipts ledger, prepared and signed the checks, posted to the disbursements ledgers, prepared bank reconciliations and quarterly financial statements. The design of the internal control structure did not reduce the level of risk that errors and fraud may occur and not be detected within a timely period by employees in the normal course of performing their assigned duties. The former Sheriff's office could have segregated these duties or implemented compensating controls by the former Sheriff, monitoring duties performed by the bookkeeper, and providing checks and balances to mitigate the control weakness.

Former Sheriff's Response: None.